

Confronting the sacred cow: The politics of work-related tax deductions

Richard Eccleston*

A common theme among recent proposals to reform Australia's personal income tax system is that lower personal income tax rates (or increased thresholds) could be partially funded through the elimination of work-related tax deductions. While such base broadening represents good tax policy in that a well-designed reform package has the potential to improve the efficiency of the income tax system without necessarily reducing progressivity, the analysis presented in this article suggests that such proposals are fraught with political difficulties.

* Dr Richard Eccleston is a Senior Lecturer in the Department of Politics and Public Policy at Griffith University. I would like to thank the journal's reviewers and Brett Freudenburg for their helpful comments as well as Claire McKenny for her research assistance. Any remaining errors remain my responsibility.
This paper was accepted for publication 31 October 2005.

Calls to reform Australia's tax system have once again gained centre stage in national political debate. The focus of recent proposals has been on broadening the personal income tax base by funding lower personal income tax rates through the removal of existing income tax expenditures and deductions.

The purpose of this article is not to assess the case for reforming Australia's income tax system, but to provide in-depth political analysis of one aspect of the broader income tax reform agenda, namely proposals to eliminate work-related income tax deductions (WRDs). While some commentators argue that income tax cuts should be made unilaterally, the vast majority advocate some form of base broadening, or funding income tax cuts through the elimination of existing income tax expenditures and deductions. Such proposals have both political and economic advantages. If reforms can be presented as being revenue neutral, it tends to simplify the politics of reform by avoiding debates about the appropriate level of taxation. Secondly, base broadening by definition will improve the neutrality of a tax system because such reforms involve eliminating the various concessions and exemptions that distort economic decision-making. While the economic and political merits of tax concessions continue to be debated, reforms which improve a tax system's neutrality enjoy popularity because they are consistent with the prevailing neo-liberal orthodoxy (Steinmo 2003, Swank 2004).

Given that a number of high profile advocates of broadening the Australia's income tax base have made specific calls to partially fund tax cuts through the elimination of work related deductions, this paper will examine the politics of such a proposal (Turnbull & Temple 2005; Freebairn 2005; Koutsoukis & Gordon 2005; Coleman 2005a). It begins with the existing literature on the growth and extent of work-related deductions in Australia before examining possible causes of their rapid growth. The paper then examines the case for reforming the current treatment of work-related deductions, before providing more detailed political analysis and some comparative perspectives.

The origins of work-related deductions

Personal income taxes were the most significant revenue-raising instrument among in developed economies over the 20th Century, and this is especially so in Australia with such taxes raising approximately 40% of total revenue (OECD 2004, 18). While precise definitions of income are both elusive and vary from jurisdiction to jurisdiction, most draw on American economist

Henry Simons' (1938) notion of income being the sum of consumption and accumulated wealth over a given period of time. In an 'ideal' and comprehensive income tax system, any income, regardless of whether it is derived from wages, capital gains, fringe benefits or gifts, should be taxed equally – or in the words of the influential Carter Commission into the Canadian tax system 'A buck is a buck is a buck' (Sandford 2000, 42). However, it is important to note that even the comprehensive income tax base proposed by Simons and promoted by the generation of public finance economists that followed, excluded consumption incurred in the process of earning income. Just as corporate income is broadly defined as revenue less costs (fixed and variable) associated with running a corporation, the costs associated with earning a wage should also be deductible. This general principle that taxable income should be defined as gross income less costs remains a central features of income tax legislation across the world and is still reflected in Treasury's definition of taxable income:

An entity's income is defined as the increase in the entity's economic wealth (stock of assets) between two points in time, plus the entity's consumption in that period. Consumption includes all expenditures, *except* those incurred in earning or producing income. (Treasury 2005, 20 – emphasis added)

This excursion into the somewhat arcane world of public finance theory is instructive because it establishes that work-related tax deductions have their origins in the public finance orthodoxy of the post-war period, and were not a form of the politically motivated tax expenditure which became embedded in some national tax systems. As we shall see below, despite the elimination of work-related deductions in New Zealand in the early 1990s and attempts to limit them in the United States and the United Kingdom (Evans 2004, 178), generally speaking, work-related tax deductions are a common feature of most mature income tax systems.

The growth of work-related tax deductions in Australia

Work-related tax deductions have long been a feature of Australia's personal income tax system, yet it has only been in recent years that their cost and consequences have attracted serious scrutiny. The primary reason for this reassessment has been the dramatic growth in WRDs since the early 1990s, with average claims increasing by 7% per annum between 1993–94 and

2000–01 to reach a total of \$8.8 billion (Warren 2004, 159; Figure 1). According to the latest data, this trend appears to have continued unabated with 6.8 million taxpayers claiming a total \$10.7 billion in WRD in 2003–04 (ATO 2005a, 10).

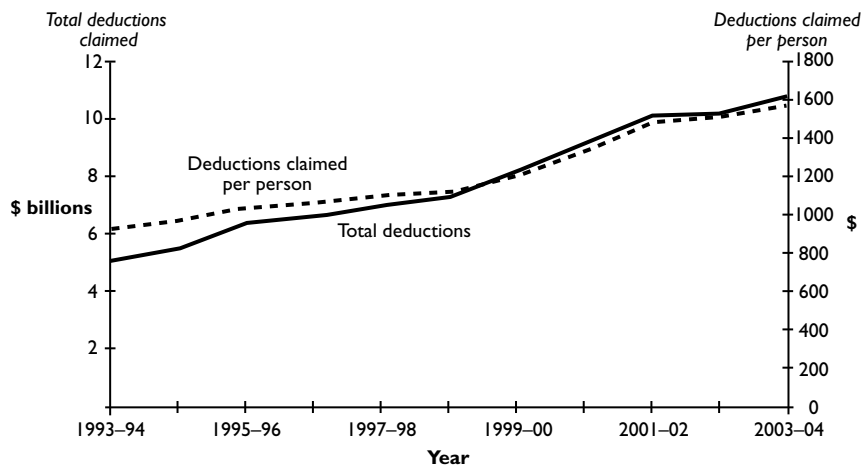


Figure 1. Total work-related deductions claimed and average work-related deductions per claimant, from 1993–2004. ATO (2005a, 2005b)

It is difficult to establish the precise amount of revenue foregone as the result of such deductions, because while the data reveals the extent of deductions claimed, we are forced to estimate the marginal tax rate that claimants were confronting.¹ As a result, estimates for the 2001–02 year (in which deductions amounted to \$9.3 billion) ranged from \$3 to \$3.5 billion (Freebairn 2005, 3) to \$4.7 billion (CPA 2005; see also Turnbull & Temple 2005, 23). In line with Freebairn's estimation, analysis conducted on the most recent data (2002–03) for this article puts the estimate at \$3.8 billion (Figure 2 and Table 1).

¹ The situation is compounded by the fact that while the deductions data is sorted by income, the income sets do not coincide with existing tax rate thresholds. There is also a threshold effect in that deductions may result in a taxpayer moving to a lower tax bracket, which also makes it difficult to calculate the exact tax saved through claiming deductions.

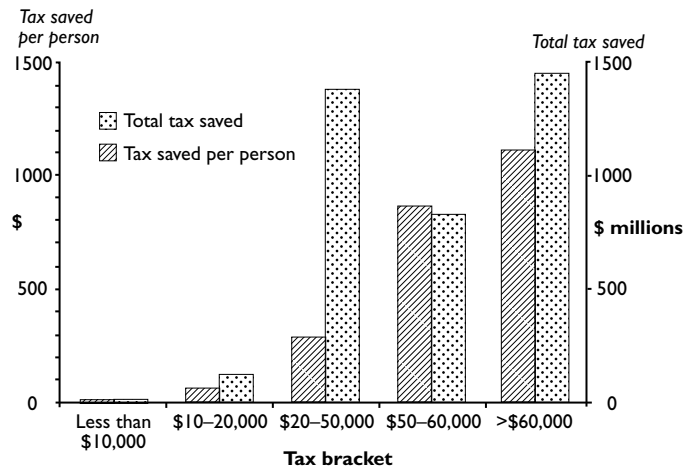


Figure 2. Estimates of average tax saved per taxpayer and total tax saved, by taxpayer income 2002-03 (ATO 2005b)²

Regardless of debates about the exact cost of WRDs to the Commonwealth Budget, there is a consensus that the revenue involved is considerable and growing faster than income tax revenue. Indeed, given the threat such growth poses to the integrity of the Australian tax system, the issue attracted the interest of the ATO well before advocates of income tax base broadening suggested that WRDs could be used to fund reforms. Initially the ATO tightened the criteria and substantiation requirements for claims. In early 2005 the ATO escalated its compliance effort when Tax Commissioner Michael Carmody openly warned taxpayers of increasing auditing activity in relation to WRDs (Anderson 2005, ATO 2005a, 7). In order to assess the likely impact of more rigorous enforcement measures it is first necessary to establish the underlying causes of the recent growth in WRDs.

2 The following assumptions were made to group ATO deductions data by 2002-03 tax brackets: 1) Of taxpayers earning less than \$10,000 it was assumed that 50% earned less than \$6000 and 50% between \$6000 and 10,000. 2) The 1.5% Medicare levy was added to the marginal tax rate of those earning above \$20,000. 3) Of wage earners with a taxable income of between \$50,000 and \$100,000, it was assumed that 50% were in the \$50,000 - \$60,000 tax bracket (42%) and 50% in the \$60,000 plus (47%) bracket. Such assumptions will result in a tendency to underestimate the value of WRDs. See also Table 1.

BRACKET CREEP AND INCREASING MARGINAL TAX RATES

One of the central drivers of increasing WRD claims is undoubtedly the fact that over the past decade nominal wage increases have exceeded periodic income tax cuts. This has resulted in a net 'bracket creep' effect for the vast majority of taxpayers. As a consequence, marginal tax rates confronting wage earners have tended to increase, providing greater financial incentives to claim deductions. For example, Warren (2004, 109) finds that the percentage of taxpayers confronting what was then the highest (47%) personal tax rate between 1994-95 and 1999-2000 almost doubled from 9.2% to 17.1% (or approximately 1.5 million taxpayers). While income tax cuts associated with the *ANTS* package (introduced 2000-01) and initiatives announced in the 2004 election campaign and 2005-06 budget have, for the short term at least, cut these numbers significantly, in the absence of indexation the number of wage earners confronting the 42% and 47% income tax rates will once again climb steadily over time. These recent reforms aside, overall the 1990s saw an unprecedented number of Australian wage earners paying the highest marginal tax rate, which seems likely to have provided incentives to maximise WRDs. The fact that deduction claims did not decline with recent tax cuts suggests that financial incentive effects in isolation cannot explain taxpayer behaviour, with assessment procedures, the nature of professional advice, and other cultural factors also contributing to the substantial growth of WRDs over the past decade.

SELF-ASSESSMENT AND PROFESSIONAL ADVICE

Classical economic theory suggests that rational taxpayers would pursue all legal (and perhaps illegal depending on the nature of enforcement and sanctions) means of reducing their tax liability, up to the point where the costs of such tax evasion exceeded the tax saved. In reality, a host of sociological factors influence economic behaviour generally, and taxpayer compliance in particular. One important factor in shaping taxpayer compliance is the manner in which the state administers the tax code – the complexity of underlying law, the compliance procedures required by the state and enforcement measures and sanctions employed to detect and punish non-compliance.

Australia, like most industrialised countries, has a mature and relatively efficient taxation system. However, since the late 1980s there has been an increasing focus on streamlining tax administration with a view to

reducing compliance burdens (Australian National Audit Office 1984). One of the most significant reforms was the introduction of a system of self-assessment for determining income tax liabilities. Introduced in 1986–87, self-assessment placed the onus on taxpayers (or their agents) to apply the relevant tax law to their circumstances and calculate their subsequent tax liability (Treasury 2004). Significantly, self-assessment involves the ATO accepting the taxpayers claims at face value, with only a small minority of lodgements being subjected to detailed audit (Dirkis & Payne-Mulcahy 2002). The advantage of self-assessment is that it streamlines tax administration by freeing up ATO staff from routine assessment processes allowing them to focus on educating taxpayers and areas of perceived compliance risk (Treasury 2004). Beyond the specific criticisms to which self-assessment has been subject by tax professionals,³ it can be argued that Australia's self-assessment regime may have contributed to the growth in WRDs for a number of reasons.

A central feature of self-assessment is that it places a greater reliance on the voluntary compliance of taxpayers. While concentrating enforcement efforts on areas of high compliance risk has generally been a successful strategy relative to the 'token enforcement' which occurred prior to self-assessment (Braithwaite 2005, 69), the ATO's current compliance strategy relies on the goodwill of the vast majority of taxpayers who are subject to a 'low intensity' verification strategy.⁴ In 2003–04 of the 6.8 million individual taxpayers claiming WRDs, 16,000 (0.25%) were asked to provide additional information while only 4000 (or one in 1700) were audited (ATO 2005a, 10). Despite the ATO's greater investment in taxpayer education, there is reason to believe that taxpayer morality may have declined over the period, which, when combined with the liberal enforcement regime described above, may be contributing to significant revenue leakage. Perhaps mindful of the escalating cost of work-related deductions, in recent years the ATO has identified the monitoring of work-related expenses and claims as a 'headline' compliance issue requiring increased education and enforcement efforts (ATO 2005a, 7).

3 Concerns revolve around the fact that self-assessment places the onus on the taxpayer to apply inherently complicated tax law and the uncertainty surrounding private rulings. Such concerns culminated in the Federal Government Review of self-assessment (Dirkis, M. & Payne-Mulcahy, Treasury 2004).

4 Part of the problem with revenue leakage from work-related deductions is that the compliance risk is spread millions of tax payers. So while individual audits may not be cost effective, the overall impact on the revenue is still significant.

Even if the vast majority of Australian wage earners don't deliberately abuse the self-assessment system, a number of practitioners have argued that self-assessment may perpetuate the *unintentional* over-claiming of such deductions (Williams 2003; Dirkis, & Payne-Mulcahy, 2002). The problem arises because of the widely held misconception that receipt of a *Notice of Assessment* indicates that the ATO has checked and approved all claims made in a given tax return (Williams 2003; Murphy & Bing 2002; D'Ascenzo & Poulakis 2002). As a result, under a self-assessment regime there is potential for taxpayers to inadvertently continue over-claiming deductions, believing they had approved by the ATO in a previous return.

The final way in which self-assessment may be contributing to the growth of WRDs is through the increase in demand for professional tax services it has created. As was mentioned above, self-assessment places the onus on taxpayers to apply the tax code to their particular circumstances. Given this responsibility, taxpayers have increasingly relied upon professional tax advice, creating a tripartite relationship between taxpayers, tax professionals and the ATO. In contrast to the late 1980s, when approximately 60% (1986–87) of individual taxpayers used an agent to prepare their returns (Pope *et al* 1990), a decade later (1996–97) this figure had increased to over 81% (ATO 1997).⁵ Taxpayers should not be criticised for seeking professional advice to maximise the deductions to which they are legally entitled; indeed the practice is actively encouraged by the ATO because it leads to the lodgement of more accurate returns. However, a likely consequence of this trend is that fewer taxpayers will under claim the deductions to which they are entitled contributing to the overall growth of WRDs.

THE CULTURE OF COMPLIANCE

Taxation is among the most coercive activities undertaken by modern governments. Reflecting this, American tax compliance expert Joel Slemrod mused:

The puzzle is not to explain why people evade, but rather why people pay taxes – in the context of the standard economic model, people who voluntarily comply are exhibiting nothing short of pathological honesty. (Slemrod 1998, 485 as quoted in Smith 2004, 180).

5 Although it must be noted that this Figure had dropped back to 74% by 2002–03 as a result of the ATO's successful e-tax initiative.

The reason, of course, why governments generally manage to raise billions of dollars worth of taxes without resorting to punitive sanctions is because the vast majority of taxpayers regard taxation as being legitimate. Indeed, as history has demonstrated over the millennia, when the legitimacy of a tax system is questioned by a significant portion of the population either because of the manner in which it is levied, or because of the way in which it is spent, then a government's prospects for survival are extremely bleak (Webber & Wildavsky; Mann 1993). Margaret Levi (1988; Braithwaite 2004) coined the phrase 'quasi-voluntary compliance' to describe the fact that while tax systems are backed by enforcement measures and sanctions, they can only function effectively if the vast majority of citizens are willing to pay their fair share of taxes. Based on extensive comparative research, Levi (1988, 53–54) argues that quasi-voluntary compliance relies on both the legitimacy of government and, significantly, the actions of fellow citizens. The key point here is that if there are widespread perceptions that a significant group of citizens are avoiding their fair share of taxes, then the normally compliant majority will be less likely to do the right thing. Such a dynamic can lead to a rapid decline in taxpayer morality and severely compromise the integrity of a national tax system.

Subsequent research has generally affirmed Levi's hypothesis, with Steinmo (2003) arguing that mass dissatisfaction with the tax system inevitably creates an acute policy problem for government and pushes tax reform to centre stage as a political issue. In Australia in the early 1970s, increasing publicity about rampant tax avoidance by the rich, while wage earners were facing increasing tax burdens, prompted the Asprey Inquiry into the Australian tax system (Groenewegen 1982, 7; Eccleston 2004, 55–56). Similarly, in the United States, growing awareness of the abuse of tax expenditures contributed to the momentum of the tax reform movement (Surrey 1973).

Has there been a decline in quasi-voluntary compliance and taxpayer morality in Australia over the past decade? While the detailed survey evidence required to answer this question is beyond the scope of this paper, pioneering Australian research by Wenzel (2001b, 2004) does tend to suggest that the compliance behaviour of individuals is influenced by their perceptions of the compliance behaviour of other taxpayers. What is clear is that over recent years there has been more public discussion of tax avoidance and evasion in Australia which may have contributed to a wider decline in the culture of compliance among wage earners.

Significant developments which may have contributed to a decline in taxpayer compliance have included the Howard's Government's reluctance to prevent the use of discretionary trusts for tax planning purposes (Fabro 2002, 2004), the concessional taxation of capital gains on assets held for more than 12 months, and the taxation implications of the growing gap between the rate at which corporate and personal income is taxed (Ganghof & Eccleston 2004). In combination, these developments have heightened perceptions that the Australian income tax system has moved from being comprehensive to effectively becoming a two-tiered system in which PAYE salary earners pay higher levels of taxation than self-employed professionals and contractors. Such perceptions reached a high point in the recent debate concerning the need to broaden the income tax base when Malcolm Turnbull candidly expressed the view that:

Anyone with substantial business income or interests is able right now to structure their affairs so that most of their income is earned through companies, which pay tax at 30 per cent. Our tax system has been designed to ensure that, by and large, the only people who pay the top rate of tax are.....PAYE taxpayers or professionals. (Turnbull 2005)

According to Levi's theory (1988) of quasi-voluntary compliance, this growing awareness of the use of trusts and corporate structures for tax minimisation creates an environment in which ordinary wage earners are going to be less willing to comply with the tax code. While such claims are difficult to substantiate, it is certainly plausible that a decline in taxpayer morality, caused by the phenomena described above, may be contributing to growth in WRDs – the one avenue by which employees can minimise their tax obligations.

While it is impossible to establish a definitive cause of the recent growth in WRDs it seems likely that economic incentives, new administration practices and the more general culture of tax compliance in Australia have contributed to the trend. The fact that broadening the income tax base would reduce both the number of taxpayers confronting the highest marginal tax rates and the growing 'rate gap' between personal and corporate income taxes lends support to the claim that such reforms would enhance the integrity of Australia's personal income tax system.

Reforming work-related deductions

Work-related expenses have been exempt from personal income tax both in Australia and abroad largely because of the established concept that tax should only be levied on net income. However, as the Australian income tax system has become more complex and the value of WRDs have escalated, a number of credible arguments for their abolition have been advanced.

First and foremost is the claim that abolishing WRDs would increase revenue by up to \$4 to \$5 billion,⁶ taxes which could be used to fund significant reductions in the personal income tax rates. For example, Labor MP Craig Emerson's proposal to abolish the second highest (42%) income tax bracket, would result in an estimated 97% of taxpayers paying a marginal rate of 30% or less and would cost an estimated \$5 billion (Emerson 2005). Similarly, one of Malcolm Turnbull's preferred reform options is a three rate regime with rates of 15%, 30% and 35% (along with an increased tax-free threshold) would cost approximately \$5.45 billion (Turnbull & Temple 2005). Clearly such changes are significant and have the potential to improve work incentives, labour supply, migration and the many other benefits promoted by proponents of income tax base broadening. Indeed, the most recent modelling published by the Melbourne Institute suggests that income tax cuts of this magnitude could generate up to 80,000 new jobs (Coleman 2005b). However, the important debate about the benefits of base broadening to one side, there are specific benefits associated with eliminating WRDs.

A taxation system in which almost seven million taxpayers claim WRDs will create a significant compliance burden. Indeed, the very existence of a regime in which wage earners have the potential to claim a host of work-related expenses, many of which are outlined in industry-specific special rulings, creates demand for professional tax services and increases the compliance burden on salary earners. Whilst the compliance issues surrounding work-related deductions are not as severe as those associated with capital gains tax and negative gearing, in combination these three elements of Australia's income tax system contribute (along with self-assessment discussed above) to between 70% and 80% of wage earners seeking professional tax advice. In 2002-03 the total cost of managing tax affairs claimed against personal income exceeded \$1 billion (ATO 2005b,

6 Recall that while the estimate presented in Table 1 was \$3.8 billion for 2003-04, given the historical growth of WRDs this implies a level of approximately \$5 billion in 2006-07.

Table 3.2). Indeed the level of spending on the preparation of personal income tax returns is such that the prominent accounting organisation, CPA Australia, recently noted that while 'the case for reviewing WRDs is arguably strong' any move to eliminate such deductions would have a significant impact on tax agents who relied heavily on preparing personal income tax returns (CPA 2004, 29-30).

A broader concern with WRDs relates to established critiques of tax expenditures more generally, in that WRDs represent public subsidies that lack the transparency of direct expenditures made through the budget process (Surrey 1973). By far the most significant class of WRDs are those concerning work-related travel (\$4.0 billion in 2002-03) and uniforms (\$1.0 billion) which raises issues about whether it is appropriate for government to subsidise costs which should arguably be borne by employers (ATO 2005b, Table 3.3).⁷ Even if there is a clear public benefit from such subsidies, which may be the case with work-related self-education expenses in the midst of a national skills crisis, critics of tax expenditures argue that such policy goals would be better met through the use of direct subsidies.

Finally, based on our earlier discussion of quasi-voluntary compliance, it can be argued that creating a taxation system in which ever-increasing numbers of taxpayers are claiming WRDs may contribute to the further erosion of taxpayer morality and a decline in taxpayer compliance. Just as evidence of non-wage earners employing aggressive tax evasion strategies may prompt wage earners to maximise their claimed deductions, evidence that WRDs are growing rapidly (now approaching \$1500 per taxpayer) may compound the problem as remaining taxpayers question whether their fellow taxpayers are paying their fair share of the tax burden. As Levi argues:

Dissatisfaction with the contract will have only a slight initial impact on compliance, especially among those whose only motivation for compliance is coercion. However, as dissatisfaction increases, more people will consider non-compliance. As people break the law and get away with it, more people are likely to begin to break the law. (Levi 1988, 53-54)

⁷ It should be noted that if employers did provide compensation for work related expenses then in many cases firms would be able to claim such costs against their taxable income. The result would be that the deduction would simply move from the personal income tax base to the corporate tax base. Thanks to the reviewer of this paper for making this point.

While such claims are inevitably difficult to verify empirically, it is important to remember that perceptions of exploitation do the damage – once the tax contract is regarded as being unfair non-compliance follows. Such arguments imply that Australia's relatively liberal WRDs regime may in fact be contributing to a 'snowball' effect, creating a culture of non-compliance and significantly undermining the integrity of the Australian tax system. If this is the case, then removing WRDs (along with the aggressive tax-minimisation strategies employed by non-wage earners) would enhance the legitimacy and integrity of the Australian tax system.

The politics of reforming work-related deductions

While eliminating work-related deductions would represent 'good policy' from the dominant neo-liberal perspective that promotes neutrality as a tax design criteria, this is not to say that abolishing WRDs represents good politics (Freebairn 2005; Warren 2004). Indeed, as the majority of political scientists will argue, the policy process is anything but rational, with ideas, interests, established institutions and past patterns of politics all shaping political dynamics. This is especially true of highly contested policy arenas, such as taxation, where political decisions have a profound effect on large segments of the community.

THE POLITICS OF BASE BROADENING

One of the main structural problems confronting governments who wish to improve the overall efficiency of a tax system by reining in concessions available to select groups of taxpayers (the central objective of base broadening proposals), are what Mancur Olsen (1965) described as 'collective action' problems. Even when there is a consensus that such reforms are in the national interest, interest group politics is such that actors who stand to lose tax subsidies have the greatest incentive to mobilise politically to protect their tax concessions. In contrast, there are few community organisations to fight for the integrity of tax systems and the national interest more generally. Often, when confronted with such pressures, governments tend to preserve established concessions rather than alienating powerful political interests (Resse 1980; Wilson 1980).

This is not to say that base broadening is impossible. Indeed the global wave of tax reform which occurred since the 1980s defied the predictions of the political sceptics as government created a constituency for tax reform. However, the fact remains that it is difficult to make the transition from

what Guy Peters (1991) has called 'self-interest' politics, which he argues is the normal state of affairs in the tax policy arena, to a more collectivist 'public interest politics' in which actors are prepared to sacrifice concessions to achieve reforms considered to be in the national interest. Just as governments, both in Australia and abroad, have confronted collective action problems when they have attempted to introduce base broadening reforms, proposals to eliminate WRDs seem likely to face similar challenges. Clearly, removing the right of seven million taxpayers to claim deductions worth, on average, \$700 per annum, has the potential to alienate a massive political constituency. While it is important to note such general arguments, ultimately the politics will be shaped by the details of any reform proposal. It is to this level of analysis which we now turn.

DISTRIBUTIONAL IMPLICATIONS AND PERCEPTIONS OF FAIRNESS

Taxation is more than a means of raising revenue and historically one of the main ancillary objectives of tax systems has been to redistribute wealth. Indeed progressive income taxation based on the principle of 'ability to pay' was one of the cornerstones of the Keynesian welfare state. While Keynesian economics may no longer be in vogue, we only need consider the recent Australian debate concerning the GST to see that distributional implications of tax reforms continue to ignite political passions invoking the rhetoric of class politics. Given the risks associated with reforms which significantly alter the distribution of the tax burden across income groups (such as the collective action problem noted above), it would be politically desirable if the elimination of WRDs did not alter the incidence of taxation. This would mean that income tax cuts funded through the elimination of WRDs would have to serve as compensation for deductions relinquished. If this could be achieved then it would allow policy makers to argue that reforms are improving the efficiency of the tax system without influencing the distribution of the tax burden.

While there are limitations to the data provided, it is apparent from Table 1 that the major beneficiaries of WRDs are wage earners in the upper tax brackets. In 2002-03 the 21% workers earning above \$50,000 reaped over 60% of the real benefits of WRDs. At the other end of the income spectrum the 35% of workers who earned less than \$20,000 received 3.6% of the benefits. Such data strongly supports Freebairn's (2005) claim that eliminating WRDs would improve the progressivity of the Australia's income tax system. Given the incidence of WRDs, it is highly likely that a

revised income tax rate structure that focused on reducing the higher rates and/or thresholds (perhaps with a modest increase to the tax free threshold) could be devised such that there was little net redistributive effect.

Table 1. Estimates of average tax saved per taxpayer and total tax saved, by taxpayer income 2002-03 (ATO 2005b). See footnote #3 for assumptions

Tax bracket	No. of taxpayers (million)	% taxpayers	Total WRD (\$ billion)	Approx marginal tax rate	Total tax saved (\$ billion)	Average saving per person (\$)	% of total tax saved
< \$10K	1.801	16.9%	0.1863	8.5%	0.0158	8.70	0.4%
\$10-20K	1.867	17.5%	0.7374	17%	0.1253	67.10	3.2%
\$20-50K	4.731	44.4%	4.382	31.5%	1.380	291.60	36.3%
\$50-60K	0.951	8.90%	1.908	43.5%	0.830	872.20	21.8%
\$60+ K	1.304	12.2%	2.993	48.5%	1.451	1,112.90	38.1%
Totals	10.654		1.021		3.802		

It would certainly be politically desirable if a proposal to eliminate WRDs could be linked to income tax reforms, such that the total package could be credibly presented as being revenue neutral, both overall and in terms of its distributional impact. However, a number of political risks remain. Firstly, any such claims are only based on aggregates and clearly individual taxpayers who make above-average WRD claims will be worse off and inevitably remain a point of vulnerability for any reformist government. In this sense base broadening of this type will fall short of being Pareto optimal.

The elimination of WRDs may also prompt wage earners to consider whether they are being treated fairly relative to other taxpayers. There is a real political risk that eliminating tax concessions available to wage earners without limiting practices used by non-wage earners to minimise their tax obligations would create a significant political backlash and lead many taxpayers to question the fairness of the Australian tax system. Unfortunately if the Howard Government's reluctance to tighten the taxation treatment of trusts is any guide, then it would seem unlikely that policy makers have the will to introduce politically difficult reforms to Australia's income tax system (Eccleston 2004, 161-164). Yet without such reforms, the task of justifying and eliminating WRDs would be all the more difficult.

THE DILEMMA OF TAXPAYER PERCEPTIONS

Another factor which would complicate the politics of eliminating WRDs is the widely held misconception among taxpayers about the nature of the tax system and amount of tax they pay. The crux of the problem, in so far as broadening the income tax base through the elimination of WRDs is concerned, is the general confusion in relation to the difference between tax deductions (or allowances)⁸ and tax offsets. The issue arises because anecdotal evidence suggests that many taxpayers wrongly believe that claimable deductions are subtracted from their tax liability (as is the case with offsets) rather than from their taxable income. This is significant because it results in taxpayers overestimating the extent of the tax subsidy of WRDs and subsequently over-valuing this concession. While I'm not aware of detailed Australian survey evidence on this issue, the fact that, in 2002-03, 440, 000 of the 1.8 million taxpayers with a taxable income less than \$10,000 (many of whom would have no taxable income) claimed work-related deductions averaging \$420, tends to support the argument (ATO 2005b, Table 15, Part C). If there is widespread confusion in relation to the true value of WRDs it would be consistent with international evidence dating back to the 1970s which suggests that the vast majority of taxpayers have little idea about how much tax they pay and the way in which income tax systems work (Lewis 1978). While such misconceptions tend to favour the case for tax cuts, with optimistic taxpayers believing they will benefit more than they actually do, it seems this dynamic works against the political case for reforming WRDs, with taxpayers overestimating the benefit of deductions.⁹

THE CULTURE OF TAX DEDUCTIONS

There is a great deal of evidence to support the claim that taxpayers are less than rational in the sense implied by classical economic theory. In fact given the complexity of Australia's income tax system, actors may be intentionally irrational (North 1990), believing that it is not worth the effort to inform themselves in relation to the intricacies of the tax law (and

8 The ATO use the term 'deduction' to describe an expense which can be subtracted from taxable income. It should be noted that the OECD use the terms 'allowance' rather than deduction.

9 An example of this were the recent capital gains tax cuts in the United States in which a poll revealed that 40% of American taxpayers believed they would benefit from the cuts when in fact 'almost all of the benefits went to the wealthiest 1% of the population. (Stiglitz 2003).

hence the need for professional advice). This, however does not mean that taxpayers are completely ignorant of and oblivious to the tax system. Instead, it is more accurate to regard taxpayers as possessing what Herbert Simon (1977) described as 'bounded rationality', with their interests shaped by a combination of rational evidence *and* social norms, established traditions and past experience. This implies that established traditions and cultural perceptions are important in shaping the interests of taxpayers and voters.

A significant problem confronting proponents of WRD reform is that the practice of claiming deductions so that tax withheld through the PAYE system exceeds the final tax obligation (resulting in a refund), has become ritualised among the vast majority of Australian wage earners. The extent to which Australians cherish these annual lump sum contributions to their household budget has been reflected in recent debate concerning the clawing back of family payments through the tax system (Pedic *et al* 2000, Wroe 2004). Similarly, related proposals to eliminate tax returns have been given a cool reception because they would increase the likelihood of taxpayers being issued with end-of-financial year tax liabilities. In short, despite being 'irrational', the vast majority of Australian wage earners cherish their annual tax return and regard it as being an important financial windfall (Evans 2004, 179). Given that eliminating of WRDs would decrease or eliminate such refunds, it represents a significant political risk to reformers, although such risks could be mitigated through re-calibrating withholding rates or by providing taxpayers with a modest tax credit in lieu of the existing WRDs (Tran-Nam 2004).

TRANSITIONAL ISSUES

The political problems outlined above relate to the likely perceptions of taxpayers that they will be worse off if WRDs were eliminated. Beyond this political discontent, such perceptions may have an impact on the economic behaviour of the taxpayers concerned, and this would have implications in the real economy. First and foremost, there is a real risk that taxpayers who lose such concessions may seek compensatory wage claims (Warren 2004, 159). This risk, and its implications for inflation and monetary policy, reinforce the arguments raised previously about the need to design associated income tax cuts such that they provide compensation for the elimination of WRDs.

There would also be countless specific economic effects related to such reforms. For example, depending on firms' ability to pay and the bargaining

power of workers, employers may not subsidise the cost of work-related travel and uniforms in the absence of a tax subsidy. Bargaining theory dictates that it will be the least powerful and most vulnerable workers who would have to meet such expenses out of private income. Similarly the removal of WRDs may lead to an under-investment in public goods such as education, training and safety equipment, although, as noted above, government could design more transparent means of achieving such policy goals. Perhaps the most interesting issue given the current industrial relations debate is that the elimination of WRDs would end the existing subsidy for trade union membership and other professional associations – an outcome which presumably would be attractive to the current Howard Government.

Conclusion

This article has outlined arguments for and against the elimination of WRDs. The broad argument has been that the elimination of WRDs represents good taxation policy in that it would create a more neutral and market conforming personal tax base if the revenue saved was devoted to appropriate income tax cuts. However, it is also worth noting that there has been a tendency in the recent Australian debate to overstate the economic benefits of flattening the personal income tax base. This point was made recently by Nobel Laureate and former Chief Economist of the World Bank Joseph Stiglitz: ‘The myth that lower taxes would unleash huge increases in savings and work effort has proved remarkably resistant to evidence’ (2003, 277).

The reality of course is that personal decisions about when and where to work are influenced by a host of factors and serious research suggests that, with the exception of a few segments of the labour market (such as women returning to work after caring for their children), marginal tax rates are well down the list of variables that influences labour supply. Putting debates about the merits of broadening the income tax base aside, this paper argues that there are inherent benefits associated with eliminating WRDs, such as simplifying Australia’s income tax system, improving the culture of compliance among taxpayers and reducing their costs associated with managing their tax affairs.

Despite the fact that a strong case can be made for eliminating WRDs, the paper has been more sober in terms of the political prospects of achieving such reforms. A combination of collective action problems and

perceived concerns about the elimination of WRDs would pose significant political challenges, even for a well-designed reform package. Given recent Australian and comparative experience, what are the prospects of the Howard government successfully meeting such challenges?

Looking abroad, there are some examples of Governments being able to meet these challenges successfully eliminating WRDs. For example, the historical *Tax Reform Act* (1986) in the United States eliminated many itemised work-related deductions, with compensation being provided through a combination of rate cuts and an increase in the general tax exemption (which works in similar manner to the Australian tax free threshold) (Tanzi 1987, Shoven 1990). While this example is significant, it must be seen in the specific context of the politics of the times, in which there was an unprecedented bi-partisan, cross-class coalition for tax reform on the back of a broad consensus that the tax system was in crisis. It is interesting to note that since 1986 pragmatic law makers have restored many itemised deductions reinforcing the claims made in this article about the political challenges associated with eliminating WRDs (Slemrod & Bakija 2004).¹⁰

New Zealand also provides an interesting case for the way in which WRDs are treated. Reforms in the 1980s and early 1990s eliminated almost all personal income tax deductions, leaving New Zealand with one of the 'cleanest' personal income tax systems in the world (OECD 2001). In terms of the politics, it is important to note that for a host of institutional reasons (a unitary state with a unicameral parliament) that New Zealand governments have considerably more capacity to push through contentious reforms relative to their Australian or American counterparts. In many ways this explains the speed and scope of the neo-liberal reforms experienced in New Zealand over the period. While there was 'some controversy' associated with the abolition of income tax deductions in New Zealand (Evans 2004, 175), there have been more widespread political repercussions associated with flattening of the personal income tax base more generally, which according to the OECD, has resulted in the 'various positive features of the system gradually being eroded' (OECD 2001, 4) This analysis tends to support the view that short of a crisis of confidence in the tax system

10 It is important to note that the US income tax base is much more complicated than in Australia. For example, interest payment on home mortgages, health expenses, state taxes are all deductible.

or an unusual consensus for reform, the politics of eliminating WRDs is difficult.

Based on historical experience there is little cause for optimism that an Australian government would be willing to confront the political obstacles associated with the elimination of WRDs. The Australian state is institutionally fragmented and opponents of reform have a number of veto options. Indeed the history of tax reform in Australia over the past thirty years has shown that significant base-broadening measures (such as the GST) have only been successfully implemented after the formation of a broad reform coalition (Eccleston 2004). The fact that similar, yet less politically less ambitious reforms, such as limiting the use of discretionary trusts for tax planning purposes, were abandoned, does not bode well for such a proposal. Finally, one of the central motivations for advocating the elimination of WRDs is to provide the means to funding reforms to the personal income tax base. The fact that Commonwealth revenue continues to exceed expectations removes the immediate need to fund such reforms through contentious base-broadening measures. Given the analysis presented in this article, the more politically expedient strategy may be to continue to fund income tax rate cuts from the burgeoning budget surplus. This would suggest that the sacred cow of WRDs may be safe for the time being.

References

- Anderson, F. (2005) 'Taxman takes tougher line on work expenses' *Courier Mail* 21/4/2005.
- Australian National Audit Office (1984) 'Controls over processing income tax returns' in *Reports of the Auditor-General on Efficiency Audits*. Commonwealth of Australia, Canberra.
- ATO (2005a) *Australian Taxation Office, Compliance Program 2005-06*. Commonwealth of Australia, Canberra.
- ATO (2005b) *Taxation Statistics 2002-03*. Commonwealth of Australia, Canberra.
- Braithwaite, J. (2005) *Markets in Vice, Markets in Virtue*. The Federation Press, Sydney.
- Coleman, E. (2005a) 'Labor targets tax breaks' *The Australian* 18/10/2005
- Coleman, E. (2005b) 'Tax cuts to place 80,000 in work' *The Australian*. 1/10/2005.

- CPA (2004) 'Reforming Australia's personal income tax system'. CPA Discussion paper available at <www.cpaaustralia.com.au>
- D'Ascenzo, M. and Poulakis, T. (2002) Self-assessment: Quo Vadis? *Taxation in Australia* Volume 36 No. 8 412-416.
- Dirkis, M. and Payne-Mulcahy, M. (2002) Self-assessment 14 years on: time for a change. *Taxation in Australia* Volume 36 No. 8 417-421.
- Eccleston, R. (2004) *The thirty year problem: The politics of Australian tax reform*. Australian Tax Research Foundation, Sydney.
- Evans, C. (2004) 'Diminishing returns: The case for reduced annual filing for personal income tax payers in Australia' *Australian Tax Review*.
- Fabro, A. (2002) 'Plans to tax trusts as companies doomed' *Australian Financial Review*. 20/2/2002.
- Fabro, A. (2004) 'Bill to close loophole for trusts' *Australian Financial Review*. 20/02/2004.
- Freebairn, J. (2005) 'Income tax reform: Base broadening to fund lower rates'. Paper presented to the 'Sustaining prosperity conference' Melbourne. Available at <www.melbourneinstitute.com>.
- Ganghof, S. & Eccleston, R. (2004) 'Globalisation and the dilemmas of income taxation in Australia' *Australian Journal of Political Science*. 39(3).
- Groenewegen, P. (1982) *Australian Tax Policy: A Survey 1965-1980*. The Taxation Research and Education Trust, Sydney.
- Koutsoukis, J. & Gordon, J. (2005) 'Union chief calls for big tax cuts' *The Age* 29/8/2005.
- Levi, M. (1988) *Of Rule and Revenue*. University of California Press, Berkeley.
- Lewis, A. (1978) 'Perceptions of tax rates'. *British Tax Review*.
- Mann, M. (1993) *The Sources of Social Power. Volume Two*. Cambridge University Press, Cambridge.
- Murphy, K., and Byng, K. (2002). Preliminary Findings from the Australian Tax System Survey of Tax Scheme Investors. *Centre for Tax System Integrity Working Paper No. 40*. Canberra: The Australian National University.
- North, D. (1990) *Institutions, Institutional Change and Economic Performance*. Cambridge University Press, Cambridge.
- OECD (2001) 'The Tax system in New Zealand: An appraisal and options for change'. *Economics Department Working Paper #281*. OECD, Paris.
- OECD (2004) *Recent trends in tax reform*. No 9. OECD, Paris.
- Olson, M. (1965). *The logic of collective action: Public goods and the theory of groups*. Harvard University Press, Massachusetts.

- Pedic, F. Stewart-Weeks, M. Rutherford, G. and Ezrakhovich, A. (2000) 'Simplifying income tax: A report on forty community consultations.' Australian Taxation Office, Canberra.
- Peters, G. (1991) *The politics of taxation: A comparative perspective*. Blackwell, Cambridge Massachusetts.
- Pope, J. et al (1990) *The compliance costs of personal income tax in Australia 1986-87*. Australian Tax Research Foundation, Sydney.
- Resse, T. (1980) *The politics of taxation*. Quorum, Westport.
- Sandford, C. (2001) *Why Tax Systems Differ: The comparative study of the political economy of taxation*. Fiscal Publications, Bath.
- Shoven, J. (1990) 'The U.S. tax reform of 1986: Is it worth copying?' in Boskin, M. & McClure *World Tax Reform: Case studies of developed and developing countries*. ICS Press, San Francisco.
- Simons, H. (1938) *Personal Income Taxation*. University of Chicago Press, Chicago.
- Simon, H. (1977) 'The logic of heuristic decision-making' in Cohen, R. & Wartofsky, M. (eds) *Models of Discovery*. Reidel, Boston.
- Slemrod, J. (1998) 'On Voluntary Compliance, Voluntary Taxes and Social Capital' *National Tax Journal*. 51(3).
- Slemrod, J. & Bakija, J. (2004) *Taxing Ourselves: A citizen's guide to the debate over taxes*. MIT Press, Cambridge Massachusetts.
- Smith, J. (2004) Taxing Popularity: The story of taxation in Australia. *The Australian Tax Research Foundation*, Sydney.
- Steinmo, S. (2003) 'The Evolution of Policy Ideas: Tax policy in the 20th century'. *British Journal of Politics and International Relations*. 5 (2).
- Stiglitz, J. (2003) *The Roaring Nineties*. Penguin Books, London.
- Surrey, S. (1973) *Pathways to basic tax reform*. Harvard University Press, Cambridge.
- Swank, D. (2004) 'The spread of Neoliberalism: U.S. economic power and the diffusion of Market-Oriented Tax Policy' Centre for European Studies, Harvard University. Working Paper No. 120.
- Tanzi, V. (1987) 'The response of other industrial countries to the US tax reform Act' *National Tax Journal* 40(3).
- Treasury (2004) *Report on Aspects of Self-Assessment*. Commonwealth of Australia, Canberra.
- Treasury (2005) *Tax Expenditures Statement 2004*. Commonwealth of Australia, Canberra.
- Turnbull, M. (2005) *The Australian*. 2/9/2005.